

CONFIDENTIAL

8 July 1981

PRIME MINISTER

UNEMPLOYMENT MEASURES: 1981/2 AND BEYOND

Prime Minister

*This is first draft
of Alan's paper.
Final version -*

1. I agree with the Chancellor's view that the Secretary of State for Employment's proposals in E(81)74 should not be adopted.
2. I attach a paper which:
- (a) questions the Department of Employment analysis;
 - (b) points out some of the deficiencies of their proposals;
 - (c) identifies some of the requirements of a better scheme for the young;
 - (d) sketches out a possible alternative approach for the young which would be much cheaper, put the emphasis on real work, and promote our wider objectives of economic recovery.
3. I am copying this minute to the Chancellor of the Exchequer, the Secretary of State for Industry, Robin Ibbs and Sir Robert Armstrong.

Fin A.

12

141

AW

ALAN WALTERS

CONFIDENTIAL

CONFIDENTIAL

UNEMPLOYMENT MEASURES PROPOSED IN E(81)74

1. The Department of Employment's analysis of unemployment in Section 1.3-1.5 of their report does not even mention wage rates. They believe that the three main factors affecting unemployment in the next 2-3 years are:
 - a. the rate at which output expands;
 - b. the trend of productivity; and
 - c. over-supply as well as the change in skill mix and technological change.

 2. I find it very difficult to understand how, either in the short run or the long run one can sensibly talk about unemployment without analysing and commenting on the predominant importance of the real wage rate. This is like the analysis of demand and supply without mentioning price! As an illustration, does not everyone believe that were the real wage rates in Britain to fall 10 or 15%, there would be a most dramatic reduction in unemployment?

 3. The tone of the report by officials is one where there is or there appears to be a given number of jobs which have to be shared out among a larger number of applicants. Implicitly it is the socialist concept of a job for one man means no job for another. It is the concept of a limited and fixed cake. But the whole point is that the cake would expand significantly with the reduction of wage costs per unit of output.
- Measures for dealing with youth unemployment
4. The main recommendation is a comprehensive scheme for the young (COSY), to be phased in to replace the current YOP. It is a general subsidised State training scheme for school leavers who are unemployed after a year. It would comprise a structured programme of training and work experience, which would presumably be closely supervised by the State to ensure that the subsidies are appropriate. If they are unable to find a job and don't join the scheme they lose their SB.

The Main Deficiencies of the Scheme

5. The main deficiencies are:

5.1 There is little or no effect on reducing wage rates both for juveniles and for others. The main reason for unemployment is the high level of wages. Unemployment is concentrated among youth because the trade unions, which are dominated by adults, keep the youth wage rate high to discourage their employment. In Germany relative youth wage rates are much lower, and so is youth unemployment.

COSY will not moderate youth wages. It will tend to exacerbate the problem. There will be, as will be shown below, an incentive to switch youth out of the normal working labour force into COSY. This will reduce the supply of youth labour on the market - an effect which the adult-dominated trade unions will applaud. Under the scheme the youths will do some work which would have been done by adult workers, but it is likely that in each company unions will ensure that this is a fairly small overlap.

In the labour market it is true that the supply of juvenile labour will be increased by reducing the allowances, making idleness on the dole less attractive. But the important point is that there is no positive inducement, in the way of low wages affecting the demand side, to enable entrepreneurs to expand their absorption of youth labour. Nor is there any knock-on effect on adult wages at the lower end of the scale, where adults and juveniles are fairly close substitutes.

5.2 COSY will create a considerable incentive to off-load existing "apprenticeships with proper training" on to the finance of the public sector. This is contrary to the Government's aim of getting employers to shoulder more of the burden of training.

The report, para 3.4, suggests that youths would be encouraged, on leaving school, to get into jobs including apprenticeships with proper training. But it must follow that there would be very considerable incentive on the part of the employer - and by suitable arrangements to the employee - to make young workers nominally unemployed at the end of 12 months and then join the

/State scheme

State scheme for the next 12 months. Then effectively the State would pick up the bill for one year of any apprenticeship scheme. Yet of course both employer and apprentice may have been perfectly happy with the present arrangements.

- 5.3 The scheme would require considerable administration and it is not clear that it would provide an appropriate training.

The claim is that the bureaucracy will be minimised by stimulating the creation of "consortia" or "networks of sponsors in a locality" and that this will reduce costs. But, as the report says, the scheme would require an expansion of the Manpower Services Commission. Furthermore it is clear that administrative costs will be minimised by restricting the YOP generally to large firms where the training element can be easily supervised. This seems undesirable at various levels. First, it will be subsidising the large firms more than the small ones. Secondly, many of the youths who join the scheme will be incapable of profiting from the additional training. What they require is the opportunity to acquire the disciplines and habits of work-punctuality, reliability, etc. But although many would be much better off working at a normal job, the incentive will be for them to go through the motions of "training".

- 5.4 Delay in implementing the scheme. The problem of youth unemployment is an urgent one, which probably deserves tackling on something like an emergency basis. Yet the paper recommends that the scheme cannot really be put into operation for another two years.

- 5.5 The budgetary cost of the scheme does not take account of the fact that such public expenditure, if raised either by taxes, borrowing or money creation, will also generate substantial unemployment. The gross and net costs are calculated only for the elimination of youths from the register and their transfer to COSY. Department of Employment apparently believes that the additional net expenditure will not cause the diminution of output and unemployment in the rest of the economy through, let us say, raising interest rates by 1 or 1½ percentage points. And since the measures are unlikely to reduce wages, and may increase the monopoly power of unions, they are likely to reinforce rigidities which increase unemployment.

The requirements of an alternative scheme

6. A better scheme would meet the following requirements:
- 6.1 It should directly stimulate the reduction of wages to juveniles, in particular reducing the wage cost per juvenile to the employer.
- 6.2 It should avoid the administrative costs of a large State administered and approved scheme.
- 6.3 It should avoid the invidious distinctions between those who are formally on training and those who are not. It should thereby avoid providing an incentive to young people (and employers) at the end of 11 months employment to become unemployed for the twelfth month in order to qualify for the scheme.
- 6.4 It should encourage school leavers to go straight into employment and stay there, if they are likely to be quickly both valuable and competent members of the labour force. Implicit in my approach is a belief that real work experience is much more valuable than artificial "training" packages.
- 6.5 It should be cheaper, ie not put at risk our whole strategy of reducing public spending.

An Alternative Approach

7. An alternative scheme would be to concentrate on the central problem of wages at too high a level to sustain a higher level of employment, and to do so quickly.
8. The best way to generate employment is to devise a subsidy, or tax remission scheme, which subsidises low wages and, by implication, penalises high wages. One way of doing this would be:

To remit the employer's National Insurance contribution for any school leaver during his first year in the labour market (or, for simplicity, any 16 year old). This remission would last for one year and would be justified on the grounds that for his

the first year he is effectively in training. But this tax remission would only apply to those earning, say, less than £40 a week.

9. This scheme would then give school leavers, without any interim period of unemployment, the opportunity to get on the first rung of the ladder. It would enable him to show that he was a reliable and competent worker. Under present legislation the employer would be able to dismiss him before twelve months expired without recourse to the employment tribunal.
10. The main advantage of this scheme would be to encourage the employer and employees to agree to lower wages for youths. It would also have some effect on the wage negotiations for adults since they would be affected by the substitutability of these low paid youths for nominally adult jobs.
11. The scheme would be politically attractive. It could be introduced alongside YOP on the present scale. It might be feasible to extend the approach to a modest outright grant, thus reducing the scale of YOP. By exempting the employer from National Insurance contributions (equivalent to 13.7% of earnings) we are recognising the training element in every first job. We can forcefully argue that we are reducing taxes on only the lower paid youths. Those who are potentially high income earners will not receive the subsidy. We can say that this is a way of subsidising a first job and giving youth a chance. There will be much less opportunity to plead that particular youths "never had a chance to show what they could do".
12. The main disadvantage of the scheme is that there would be a temptation on the part of the employer to fire the youth at the end of his first year of employment. But any youth who had proved himself, would be likely to be retained by the employer. Those who would be again on the dole at the end of the first year may find it more difficult to get employment than in the absence of the scheme. But this will be mitigated by:
 - a. the effect of bringing down real wages, which will ensure that there are more jobs available; and
 - b. the value to potential employers of genuine work experience acquired.

/13. It might

13. (It might make sense to ease the transition to the normal regime by having a ½-rate employer's contribution for 17 and 18 year olds.)
14. The other aspect of the scheme that would make it unwelcome in some quarters would be the encouragement it gives to employers to substitute young employees for adults. We see this as a benefit, tending to depress wages elsewhere and thus expanding employment. But the trade unions will, of course, see it quite differently.
15. This scheme could probably be introduced rather quickly and would require fairly minimal supervision. It would not require for instance employers to register and form the "consortia" that is required by COSY. All employers would automatically qualify, provided they paid the £40 a week or less wage. Similarly, there would be no need for any detailed inspection of training. The presumption would be that all first year employees were receiving some relevant training. In any case this approach would put much more emphasis on the value of real work experience as the most important training requirement.
16. This alternative scheme is presented here in only general terms. It is not at all clear that either the subsidy element, in terms of eliminating the National Insurance contribution or the £40 maximum, are the best values. A little study may show that they are quite wrong and different numbers may be appropriate - even including a modest outright subsidy. It is only suggested that the general principle of subsidy with a maximum wage restriction is the appropriate way to proceed.

Other measures to remove obstacles to employment

17. Of course we continue to believe that removing young people from the purview of wages councils would be beneficial. We have argued elsewhere that it would be better still to abolish them altogether.

Labour supply and early retirement

18. The concept of a fixed number of jobs is again dominant throughout the discussion of early retirement. The measures are partly

/cosmetic

cosmetic, as in the case of the early retirement long-term unemployed, and partly designed to reduce output and maintain the level of wages. For example the compulsory retirement of civil servants at 60, would mean that the Civil Service would not have the option of retaining those workers whose productivity is high, and considerably in excess of the wage rate, while at the same time requiring those to retire at 60 whose performance has been not more than barely satisfactory. Compulsory retirement would then increase the costs of operation of the Civil Service. (On average the newly recruited member would have, of course, normal productivity, whereas those retained after 60 would have much higher productivity, relative to their wage.) Similarly, the suggestion that the earnings rule not be relaxed is a method whereby those who could productively engage themselves in employment, with benefits both to themselves and their employer, would be, and indeed are, discouraged from production. (Again the concept of a limited cake and the refusal to contemplate a reduction in the wage rate generating jobs and output.) One of the advantages of the relaxation of the earnings rule would be to generate a supply of relatively cheap labour which will, of course, have effects on wage negotiation throughout the relevant occupations.

19. ^{of the report} Throughout this section/the thrust of the argument is to discourage people from working, in the hope that somebody else from the unemployment register will get the job. A fixed cake again. Yet surely the whole point of the Government's policy has been not to discourage people from working, when it is mutually advantageous to both employer and employee. It is possible, as we know in the United States, that many employees would rather take a wage cut than retire. They prefer to carry on working. Such a wage cut would have, of course, beneficial effects on employment. Yet the Department of Employment paper does not even consider these. (Although it discusses rather sniffily the partial retirement used in Sweden.)

8 July 1981


ALAN WALTERS